DOW THEORY LETTERS INC.

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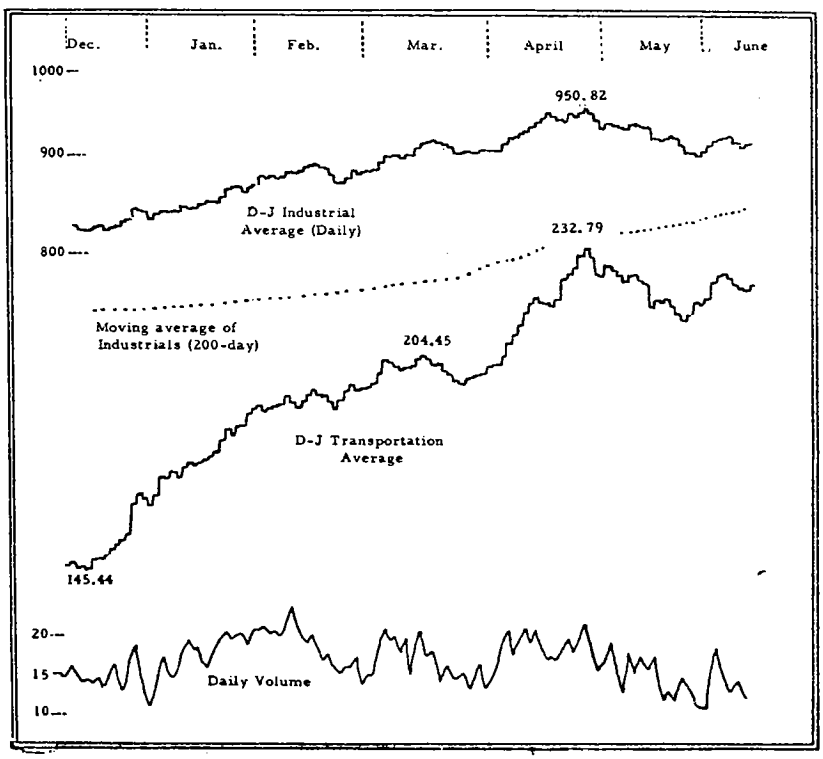
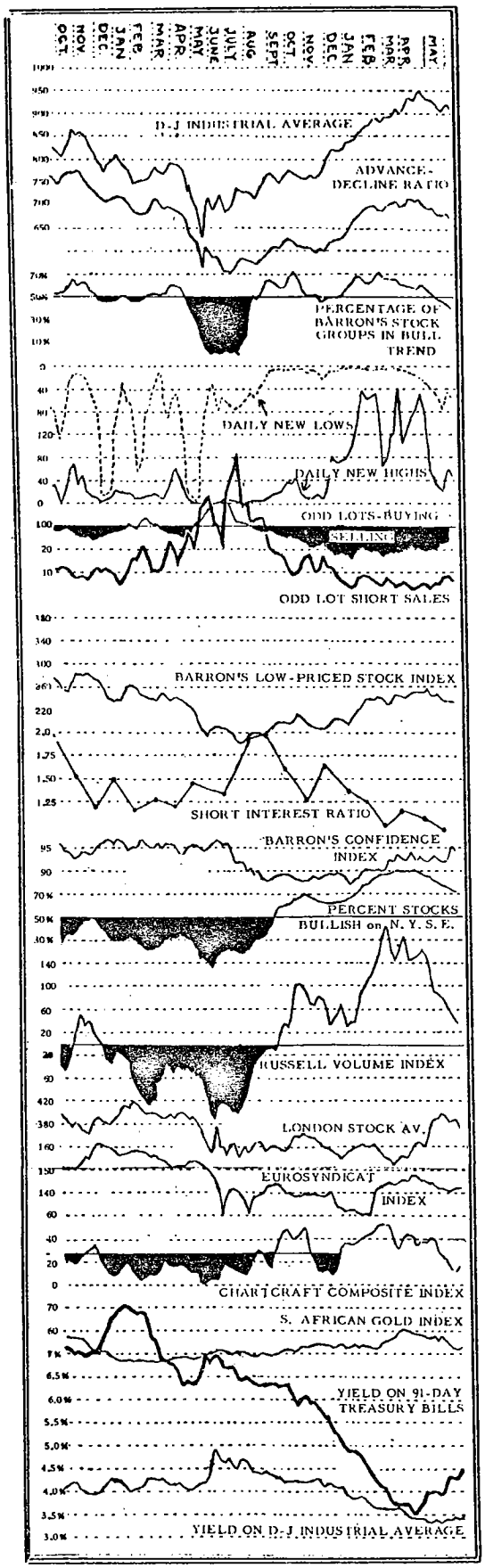
"But thou shalt have a perfect and just weight, a perfect and just measure shalt thou have: that thy days may be lengthened in the land which the Lord thy God giveth thee," Deuteronomy XXV, 15.

Meanwhile, the German mark, bellwether currency of Europe, "floats", and the eyes of the business world are on the international trade figures. For if the mark can no longer be converted into dollars, this means that all sorts of currency dislocations are now either occurring or are in the cards. Dislocation of international trade will be the result. The dollar is now like a ship without a rudder, being so fractionally backed by gold as to have no stability. As a result, confidence in the dollar, the reserve currency of the Free World, was never lower. As stated so well in the latest "Holt Investment Advisory", "Importers and exporters must know in advance how much their product will cost, lest their profit margins disappear overnight. And floating currencies make such knowledge impossible".

As I see it, two distinct possibilities loom. One is that our European creditors are going to turn the pressure on, forcing the U.S. to deflate, and forcing the dollar back towards a position of stability. The other is that the German mark will be revalued or "stabilized" against the dollar, but in this case the U.S. will attempt to continue inflating. Then we will see the "solution", as Atlas Magazine puts it, that "....they all dread: a tragic return to individual capital controls, protectionism and the inevitable trade war".

THE STOCK MARKET has been gauging and measuring all this as it fulfills its function of discounting and looking ahead. I have included a tracing of six important indices (courtesy of Comparative Market Indicators, Box 1557,





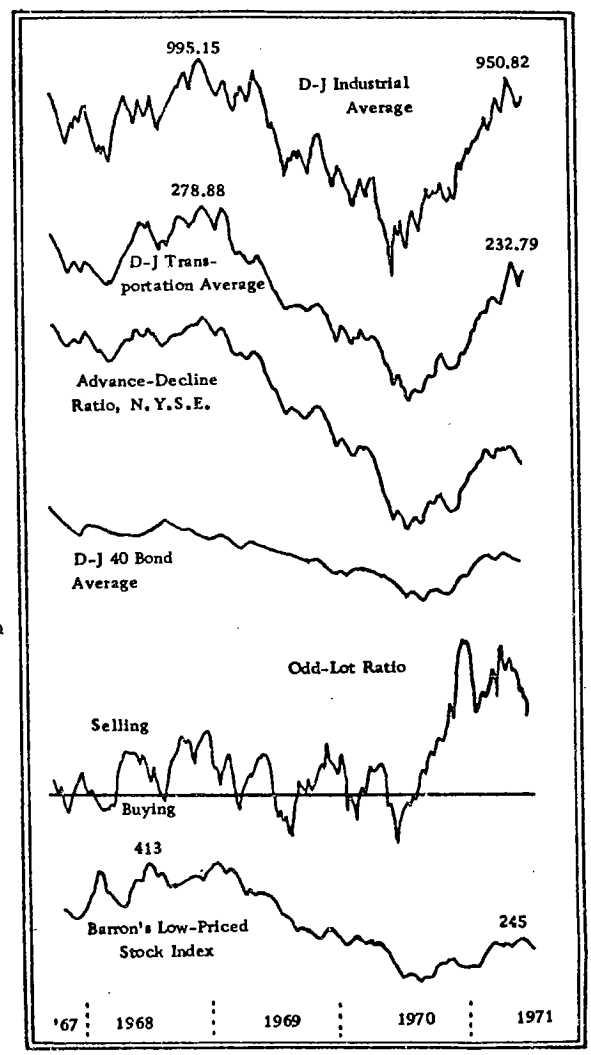
 Bellevue, Wash.), and I believe these will help readers to see where we are.

Years ago I described my "bathtub principle", and this principle states that the entire market can be likened to a bathtub, tub filling up during a bull market, and a tub emptying during a bear market. Since February, 1966, I believe that wly and very subtly the water has been running out of the market tub. I have shown the action of the first "crash", which occurred in 1969-70, and the action since then. It is sufficient to note that not one of these important gauges has pushed above its 1968 peak, despite wild inflation in both prices and the U.S. money supply (except the odd-lot ratio, which is not a price index).

Note that the advance-decline ratio has been notably weak, and this is a broad measure of the advancing or declining tendencies of the majority of stocks on the N.Y.S.E. Note also the lackluster and token rally in the very important D-J 40 Bond Average. With numerous major monetary crises occurring since 1966, the recent sub-standard rally in the 40-Bonds hardly suggests that the market sees clear sailing ahead on the money front. When this primary bear market actually ends and the real new primary bull market starts, I expect the 40 Bonds to enter into a major rally, a rally which will unmistakenly indicate that money and credit have seen the worst and that bonds are at unbelievable bargain levels.

The odd-lot ratio indicates that the small buyer has been very skeptical during the 1970-71 advance and has remained consistently on the sell side, despite the fact that the funds loaded up to the point where their cash position is now a very low 5.5%. Nevertheless, it is also probable that the odd-lot ratio has seen its peak of bearishness and is now heading in the direction of less selling, which is not a good omen for the market.

Finally, as I have stated many times before (and this is a little understood principle), once the low-priced stocks top out at or near the peak of a bull market, they seldom come back. It was a stock market "first" when the L-P Index bettered its 1966 high during the bear market rally of 1967-68, but this was not fated to repeat during the 1970-71 bear rally (following the 1969-70 collapse). As you can see, Barron's L-P Index has been notably sluggish on the 1970-71 rally, and I would say that the 1968 peak on this Index will stand for many years to come.



On the nearer term, it is notable that the relationship between the Dow d the advance-decline ratio is becoming rather bearish. On May 28 ue A-D ratio broke back to its mid-January level, thereby wiping out all gains since January 18. This loss on the A-D ratio was equal to an Industrial drop to the 860-70 level. On the rally since May 28, the A-D ratio has been outstandingly sluggish, and if Industrials made a "summer rally" try to a new 1971 recovery high, it would be almost certain that a wide divergence between the Dow and the A-D ratio would be opened up.

This gives the Dow the "choice" of developing a divergence on the upside or confirming the A-D ratio by dropping below the 870 level. Either way, the technical dilemma is looming large. I will go into this in more detail in the next Letter, but the whole picture suggests to me that the bear market probably saw its rally peak in April at 950.82 on the Dow.

THE UNWINDING: Few people are aware of it, but I believe we are now moving into the period of the "great unwinding". This is a period in which the machinations, the huge, inflated edifices, the complex superstructure of the 1949-66 bull market are fated to unravel.

If one is an avid reader, he can see signs of it almost every day. Last week, for instance, we learned that Penn Central is planning to sell off about $1 billion of its choicest New York City property, "the family jewels" as Newsweek put it. Many real estate people believe that this will prove to be a disaster, since it will entail the competitive raising of huge amounts of money (for purchase), and possibly result in vastly lower prices than Penn Central now imagines it will receive for its properties.

At the same time, a Senate committee debated the merits of lending Lockheed, greatest defense contractor in the Western World, $250 million

or allowing this titan to go under, taking with it countless smaller contractors and sub-contractors in a bankruptcy which could have fantastic repercussions.

Meanwhile, Grumman, in the light of a $2 billion cost "over-run", faced the possibility that its F-14 fighter plane would be cancelled out entirely. The F-14 program, incidentally, runs in the neighborhood of $10 billion.

On June 5, Business Week stated in its "outlook" column, "One of the props under the business recovery has just been weakened: Capital spending plans have been revised downward". It now turns out that business intends to spend only 2.7% more than in 1970, with manufacturers expecting to spend 4.2% less. Only six months ago Commerce's figures showed that business was to spend 6.5% more than last year. Thus, the spending plans of American business are being revised downward.

Hopes for a rise in consumer spending are not enough to keep the "recovery" going. What is needed for a real recovery is a rise in business inventories and capital investments. Neither of these is in the cards, and neither is slated to help the economy during 1971.

At the same time, the forces of inflation are in full force. Last week three major aluminum companies agreed to a whopping 31% wage increase over three years for its workers. Aluminum Co. of America immediately raised all fabricated prices 6%. The Aluminum settlement was considered the minimum that the steel workers will shoot for in their coming negotiations, regardless of the fact that American steel is already priced out of world markets. Through it all, the White House mumbled its usual sounds of dismay.

On the money front the pressure was building again. Latest astounding estimates are that the Federal deficit for the year ending June 30, 1971, will be around $22 billion, and that the deficit for the year ending June 30, 1972, will be $23 billion, adding up to an horrendous peace-time record of $45 billion in deficits in two years! In the face of this, money rates were moving up, bond prices were again moving down, and as Eliot Janeway puts it, "The fact that Washington's galloping bankruptcy rate of borrowing has put rates up during the spring season for fiscal ease would be pointing to an autumn crunch of crisis proportions even if the far from resolved dollar problem in Europe were not already staging a preview of the next phase of squeeze in the money markets".

The worst of two worlds, simultaneous business decline and inflation, seems to be one possibility, and Dr. Burns of the Fed. perhaps hopes to ward off the latter with price and wage controls. Bank of America last week took cognizance of the whole situation as it raised mortgage interest rates and boosted the rates it pays on long-term deposits. The new money squeeze, in my opinion, is now beginning, and this time it will be the Federal Government which will do the squeezing, via massive borrowings to finance unbelievable deficits.

Some of the airline earnings are coming out, and here the picture is so bad that one can only wait for the eventual "thud" which will turn the public's attention to the mighty problems which face this industry. For instance, TWA announced that it lost $41.2 million in the first 4 months of 1971, despite "better cost controls" (traffic was down), and this compares to a total (restated) of $63 million lost by TWA last year. Pan American stated that they lost $32 million for the first 4 months of '71. It seems to me that the airline industry is unraveling before our eyes, and it would not surprise me to see drastic legislation, mergers, bail-out attempts and other measures instituted here amid an atmosphere of bankruptcy.

I could go on and on with this type of news. I could go into the April drop in new durable goods orders, the April drop in machine tool orders, down 17% from March. Suffice it to say that the business recovery is turning into a farce, and I believe we will shortly see the bear market start taking hold in the economy again. This, as stated before, should assume the early form of an unraveling or unwinding process. Each brick pulled out unsettles the next brick, until the entire edifice becomes unsettled and shaky. This shakiness is the preamble to panic in business and the economy, and it would not surprise me to see this kind of activity going on during 1972.

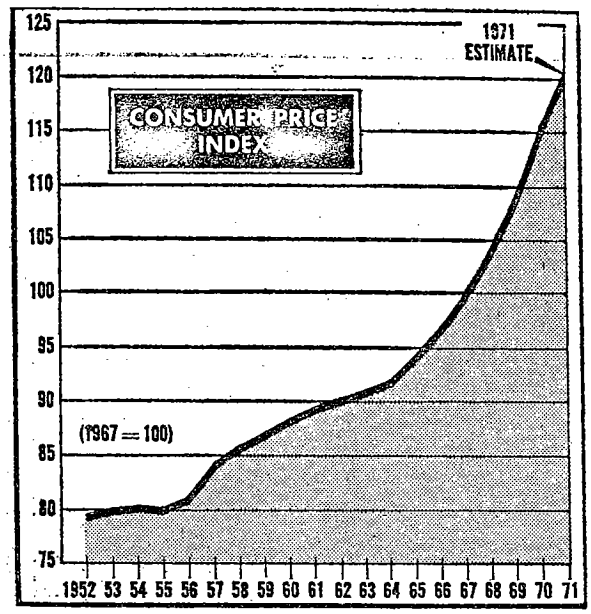
FUNDAMENTALS: The primary bear market, ending the greatest primary bull market in history (a 17-year bull market lasting from 1949 to 1966) began in February of 1966 at 995.15 on the Dow Industrials. As I see it, two major bearish forces have lurked in the background since then. The first is the problem (some refer to it as the crisis) of the dollar. The second is the problem of U.S. business itself.

In the last report I attempted to analyze some of the main problems of the dollar. Obviously, this is a titanic subject, and to know the full meaning of the dollar problem would be beyond the ken of any single individual. However, to this observer it is clear that what is happening is that the U.S. has both outpriced itself in world markets and pursued policies which have been far beyond its means. These policies have included everything from massive arms-give aways and giant domestic programs which were not properly financed, to the more recent huge manipulations of the U.S. debt. The debt manipulations alone are so involved and "far-out", so numerous and complex that I doubt if a Congressional committee, working day in and day out for a year, could come up with the full scope of what the U.S. has been doing to prop up, hold up, and support the U.S. dollar in world markets.

Recently, the U.S. has been selling foreign currency short, and these shorts will have to be purchased in coming months, they have been selling obligations with gold clauses, and those clauses contain stipulation that they may be paid back in $35 gold (with gold now $40 in the free market). The U.S. has also been sopping up Eurodollars with obligations bearing interest rates well above prevailing interest levels, in an attempt to take some of the towering mass of Eurodollars off the market.

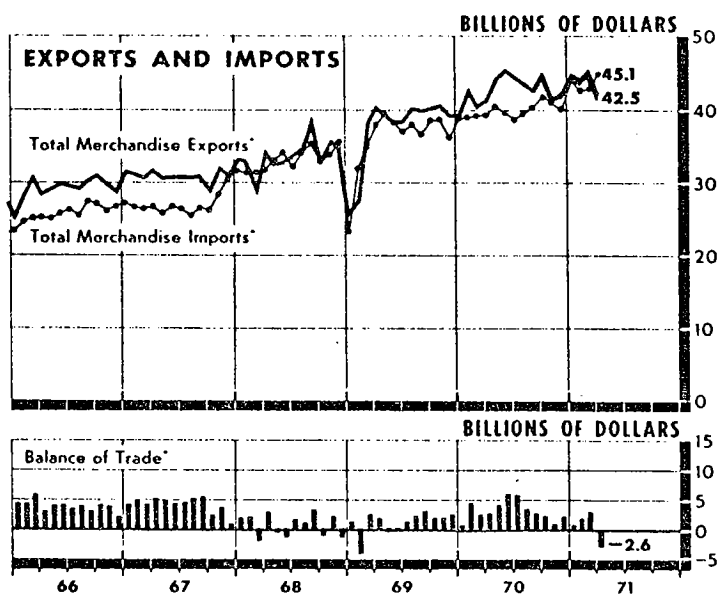
When an addict goes on heroin he has to keep upping the doses in order to say "high". The longer he stays on the drug path, the greater the expenses, and the more involved he is likely to get in dangerous procedures, all in the effort to satisfy his dismal and pathetic need. Sooner or later, a choice must be made. The addict must "unwind", get off the drug, or face death. There is no indefinite upper limit for the heroin user; the final choice always stands before him like the "writing on the wall". Unwind, get off, or die.

As I see it, the path of inflation, monetary debasement, debt-building, monetary manipulation parallels the path of the drug addict. Ultimately, the nation following this path must face the truth, and that truth is that it must pay for its excesses in a logical, planned, sane way — or face collapse. I believe that the primary bear market which began in 1966 was beginning, just beginning, to discount this story as it started. In other words, these were some of the seeds which germinated, setting off the bear market.



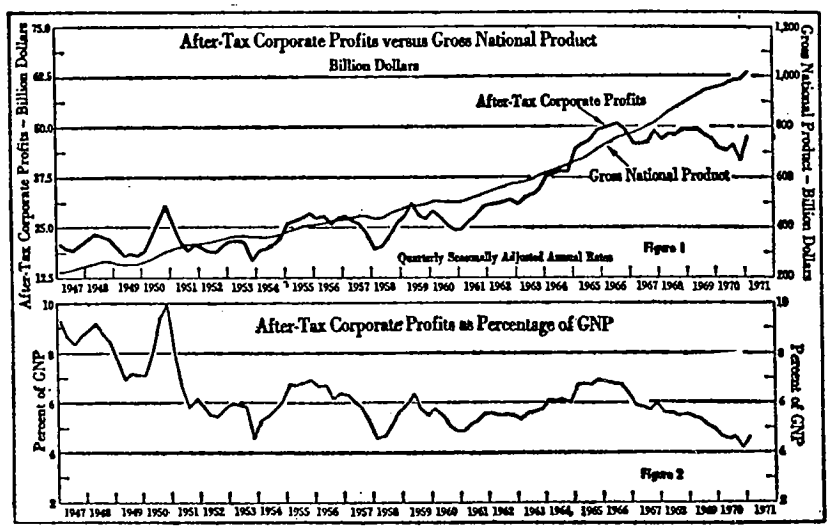
Then we come to the second problem, business itself. In many ways, the problems previously mentioned directly or indirectly affect business. In order to show some of the phenomena which are now occurring in the business picture, I am going to use a few charts. The first chart is clear enough, it shows the Consumer Price Index, and this is one of the factors which the man on the street "feels" directly. He knows when the price of a car goes up; his wife knows when the price of steak goes up. As can be seen on the chart, the price of just about everything has been rocketing up at what appears to be an accelerating rate. This, of course, cannot go on. Not without a massive intervening correction, it can't. The history of prices over the last 5,000 years will tell you that. The Bible even talks about it when it mentions the seven fat years and the seven lean years.

This brings us to another problem. When inflation runs rampant, it becomes progressively harder to sell your product overseas, particularly if your customer has other cheaper sources from which to purchase. And that is what has been happening to the U.S. as this second chart from the Harris Trust and Savings Bank illustrates. This spring, for the first time since early 1969, American imports exceeded exports. Note at the bottom of this chart that the Balance of Trade has been trending down ever since mid-1970. Then last month it went unfavorable (vertical bar below zero). All this adds to the persistent weakness of the dollar.

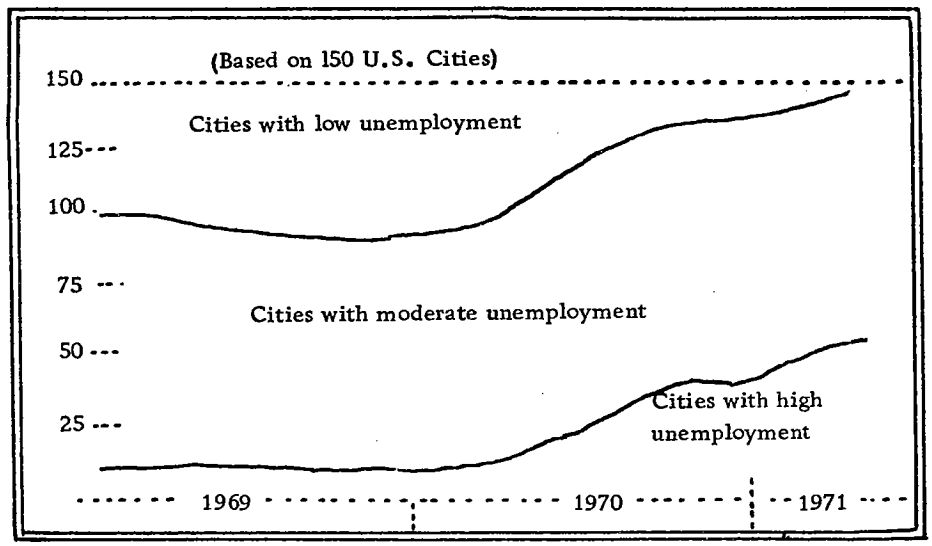


My third chart (on page 5) from the Journal of Commerce shows another vital segment of the American business picture, profits. Note that despite the steady climb in Gross National Product, corporate profits ominously refuse to follow. A simple reading of this chart would suggest that despite rising sales, profits could not even hold their own. This is shown clearly at the bottom of this chart under the heading "After-Tax Profits as a Percentage of GNP".

Not good, but not really frightening yet, the question is, what happens if and when GNP turns down. In that case, I believe we will see profits literally disappear (as fixed expenses hold while sales volume falls off). This is the lurking danger in the picture, and it underscores the Administration's terror of any business slowdown.


After-Tax Corporate Profits versus Gross National Product
Billion Dollars
After-Tax Corporate Profits
Gross National Product
After-Tax Corporate Profits - Billion Dollars
Gross National Product - Billion Dollars
Quarterly Seasonally Adjusted Annual Rates
Figure 1
After-Tax Corporate Profits as Percentage of GNP
Percent of GNP
Figure 2

Finally, I am showing a chart which is perhaps most frightening of all, both to the Administration and to the American consumer. The chart shows the Labor Departments 150 U.S. cities and divides these cities into three classifications as shown. At the low point of the 1970 "recession", the Labor Department showed only 16 cities in the "High unemployment" category (6% or more unemployment). At the end of 1970, there were 37 cities in that classification. In May the figure had risen to 52, and in June three more cities were added, making the total 55 or the highest figure since April, 1962. In his June 2 report, economist Eliot Janeway points out that the three new unemployment additions, Saginaw, Michigan, Duluth, Minn., and Middletown, Ohio are a bad omen in themselves. Janeway points out that the ominous implications of the additions of these three cities to the high unemployment list is that the cities are in "exactly those sectors of the economy where the news in the making figures it to be best". Saginaw, for instance, is right in "auto territory" where we are supposed to be seeing a pick-up in car sales.



To me, the answer to the puzzle is clear. This business "pick-up" we are now witnessing is one of the biggest hot air and propaganda efforts in U.S. history. Every plus statistic is touted to the sky, every minus statistic is buried. Hardly a day goes by without some Administration spokesman telling us (or our foreign creditors) that "everything is all right", and that the Administration has all in hand. With mutual funds now "fully invested" with cash down to 5.5% of assets, it becomes a job of distributing stocks to the public just as much as it is a job of distributing nonsense to the public regarding the strength of this economy.

All of which should make for a mighty hairy and exciting picture for the rest of the year 1971. Despite the fact that 90% of Wall Street and the country is supposedly convinced that we are on the upward path again, I sense a very obvious and widespread undercurrent of suspicion, cynicism and downright disbelief. My mail has never been heavier (I can't possibly answer it all) and most of the mail contains "hidden" little articles from sundry publications, all pointing to the true facts about what is really going on in the nation (mostly from local newspapers). To put it mildly, what the public suspects is far different from what the Administration wants them to believe. It should all be a lot clearer and out in the open before 1971 is out.

LATE NOTES: I have been saying all along that the peak of the post-GM strike recovery move in this weak "economic recovery" would probably come in the current (second) quarter, and that business would then deteriorate to the end of the year and into 1972. On June 14 the Wall Street Journal (see clip page 6) finally let out the news: the auto recovery is

sub-standard and the only thing really booming is foreign car sales.

So with capital spending dragging that leaves only the widely-touted housing "boom" to shout about. With that in mind, I thought this little chip from the June 15 Forbes was more than fascinating. The current business "expansion" continues to be more Administration mouthings than fact, and the underlying forces of the bear continue to build for the onslaught which should be on in full before this year is out.

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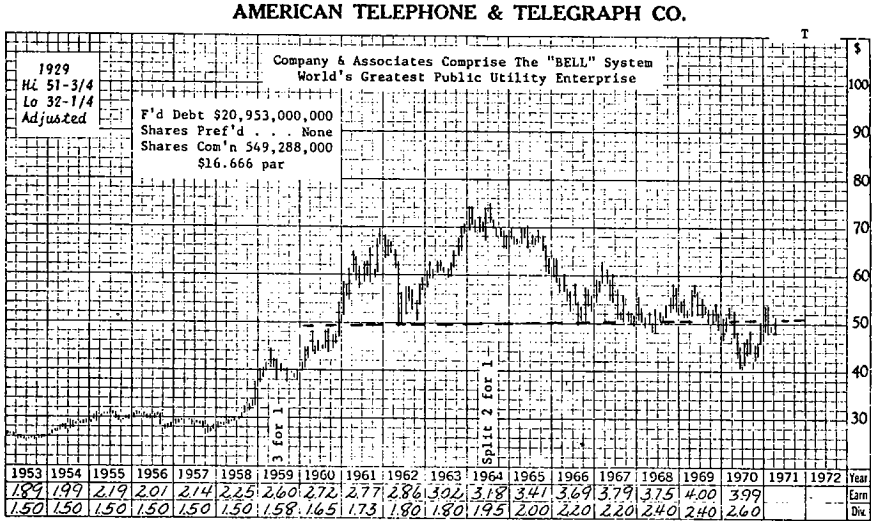
General Motors' rebound after its two-month strike last fall has failed to produce the expected economic ripple-effect. Although GM had record first quarter production, U.S. auto sales generally remain modest, and GM operations have settled back to levels that are disappointing to its workers, suppliers and even its competitors.

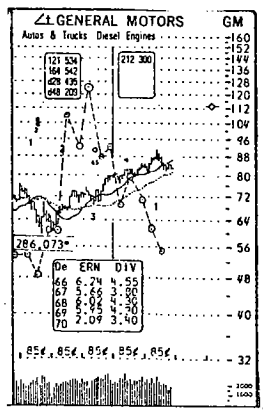
Boom or Blah?

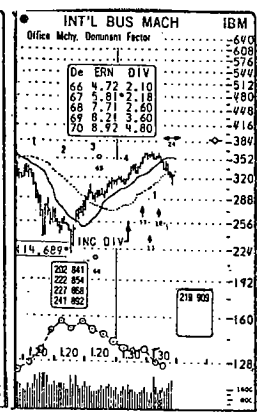
The most frequently cited proof of a current economic recovery is the "housing boom of 1971." Now that boom is being challenged by some industry observers as being partly a product of false government optimism and bad arithmetic. For example, the National Association of Mutual Savings Banks charges that the government is including units subsidized by government assistance programs and thus distorting the picture of what the private housing market is doing. Federal programs this year should aid 500,000 units of "private housing," according to NAMSB. Said a spokesman, "Even a 2-million-unit total would mean less than 1.5 million unassisted housing starts, which is hardly impressive and was frequently exceeded in the 1950s and 1960s."

STOCKS: Back in 1968 I included a chart of American Telephone, most widely-held equity in the nation. At that time I drew attention to the massive "head-and-shoulders" formation in this stock and warned that Telephone could go the way of the steels, sinking into a mire or spiraling debt with an ultimate squeeze on profits. The accompanying chart (from M.C. Horsey, Salisbury, Md. 21801) shows the up-dated formation in Telephone, and we note that the

AMERICAN TELEPHONE & TELEGRAPH CO.







stock has again climbed laboriously up to the "neckline" of resistance (dashed horizontal line) and is now heading down again. The chart tells me that conditions are poor at Telephone, and that the 1970-71 "recovery" was pitiful.

The two smaller charts from Quote Digest (P.O. Box 213, Wichita, Kansas 67201) show two other corporate bellwether giants and their rallies in this bear market. General Motors barely bettered the halfway level of its 1965 to 1970 decline (113 to 59) during the 1970-71 rise, but GM is now acting quite poorly. Back in Letter 490 I showed a very long-term chart of the auto industry, and I stated that this industry could have seen its peak in relative strength (or performance compared with the general market) for decades to come. I still stand on that statement.

Finally, mighty IBM proved to be a bit of a shocker by hitting a new low for the year last week. My own guess is that foreign competition and sales are going to prove progressively rougher for this "greatest of all growth stock", and it would not surprise me if the 1970 IBM peak of 387 did not represent the peak for this issue for many years to come.